
Preparing Consolidated Financial Statements in Accordance with IFRS

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Abstract:

The article considers specifics of preparation of consolidated financial statements in Kazakhstan companies in accordance with international financial reporting standards.

This article considers the features of the preparation of consolidated financial statements in Kazakhstani organizations in accordance with international financial reporting standards that are necessary to provide accurate and fair information on the economic activities of the Group. The IFRS reporting ensures more accurate assessment of the financial status of the company, its changes, the results of the Group's performance, as well as it enables a greater independence of decision-making.

Keywords: *integration, consolidated reporting, consolidation, parent organization, subsidiary, group, control, minority interest, dividend policy, adjustment, international standards.*

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I. Introduction

Business combination is an important factor in the development of the modern economy. The synergetic effect arising in the operation of an integrated group of companies provides a cumulative impact that exceeds the sum of the impacts of separate companies before the consolidation. Large transnational corporations whose shares are listed on stock exchange and which operate globally mostly prepare consolidated financial statements. At the same time, the function of consolidated financial statements is not purely informational, since it is aimed at a certain group, i.e. investors and shareholders. Consolidated statements provide a more objective outlook on the operations and financial situation of an economic unit, but do not substitute separate financial statements of a company that is a part of the group since they represent its economic relationships (Liapis and Thalassinou, 2013; Thalassinou and Liapis 2014; Boldeanu and Tache, 2016; Budik and Schlossberger, 2015).

Such statements can perform the control function of the parent company and determine its dividend policy (Golovina and Golovin, 2013). Consolidated financial statements enable to provide accurate and fair information about the business activities of the group. Statements prepared according to the international financial reporting standards (IFRS) should meet very high requirements associated with the transparency of information. The statements complying with the IFRS provides a more accurate outlook on the financial status of the company, its changes and the results of the group's work, as well as they ensure a greater independence in decision-making (Theriou, 2015; Tsamis and Liapis, 2014, Theriou and Aggelidis, 2014; Hapsoro and Suryanto, 2017; Kalanotnis *et al.*, 2014).

Using the IFRS, Kazakhstan companies can provide external users with required financial information; this also facilitates Kazakhstan's integration into the world economy. Representation of business combination in the consolidated financial statements is a relatively new issue, and its methodology requires further development.

In accordance with the law of the Republic of Kazakhstan of 20 February, 2007 No. 234-III "On Accounting and Financial Reporting", the transition from the Kazakhstan Accounting Standards (KAS) 13 to the International Financial Reporting Standards (IFRS) 27 should be implemented in stages, namely: 2012-2015 – mandatory transition to the IFRS of consolidated financial statements (On Accounting and Financial Reporting 2007).

However, as many international experts admit, this challenge turns out to be difficult and totally new even for countries with developed market economies that have been applying the IFRS for quite a while. In addition, in the Republic of Kazakhstan accounting regulations strictly regulate this procedure, in contrast to the IFRS where their application is largely based on the professional opinion of the accountant. Therefore, taking into account the specifics of accounting in Kazakhstan, it is

necessary to provide a more detailed specification of the procedures required for drawing up consolidated financial statements in accordance with the IFRS.

II. Goals

Issues related to the preparation of consolidated financial statements make up a significant part of the IFRS. The main ones, in our opinion, are IFRS 3 Business Combinations, IAS 27 Consolidated and Separate Financial Statements, IAS 28 Investments in Associates, and IAS 31 Interests in Joint Ventures. In addition, this issue is explained in SIC-12 — Consolidation – Special Purpose Entities. These standards set forth the principles and requirements for how business combination is represented in the consolidated statements, namely:

- how to determine which companies should be included in the consolidated group;
- how to identify and evaluate the selected assets and liabilities of controlled entities;
- how to determine the goodwill acquired during business combination, or income from a profitable acquisition;
- how the components of the group's capital and the non-controlled share are formed;
- what information should be disclosed to enable the users of financial statements to assess the nature and financial consequences of business combination (PwC2016).

When drawing up consolidated financial statements, the most important task is to define the scope of consolidation. The control of relationships between companies is a prerequisite for their consolidation. In accordance with international standards, when an enterprise controls some other enterprises, it should include data on all controlled entities in its consolidated statements (Uvarova, 2013).

According to this standard, control means the right to determine the financial and economic policies of companies for the purposes of benefiting from their operation. If the control over a subsidiary is temporary, this company shall not be included in the prepared consolidated financial statements. Control is considered temporary if the enterprise intends to sell the investment in the subsidiary within the next 12 months from the date of purchase and the management is working on this sale. For this case, one should apply IFRS 5 Standard. If the investment in a subsidiary is not classified as held for sale in accordance with IFRS 5, then it shall be stated in the investor's individual report either at cost or at fair value in accordance with IAS 39.

It is believed that the company is controlled when the parent company directly or indirectly owns more than half (50%) of its shares. Control is also exercised if the company owns half or less of the votes of another company, but has the following powers:

- determines the financial and economic policy as stated in the company charter or agreement;
- appoints or dismisses the majority of the members of the board of directors or a similar management body;
- elects the board of directors by a majority of votes at meetings.

Consolidated financial statements should contain a list of large subsidiaries and state the reasons for including them in the consolidated financial statements (if any) and the nature of the relationship between the parent company and subsidiaries (if the parent directly or indirectly owns more than half (50%) of the subsidiary). Such statements should include the names of companies that are not subsidiaries (as being non-controlled), despite the fact that the parent company owns more than half (50%) of its shares (hence the company shall be included in the scope of consolidation).

However, a model built according to the principle of a “legal form of control”, as experience has shown, is inappropriate. The presence of control should be determined not based on the legal form, but according to its economic substance (IFRS Memorandum). In accordance with the current IFRS system, control is defined as the ability of the parent company to manage the financial and operational policies of the subsidiary in order to obtain certain economic benefits. As a rule, control is connected with property, i.e. direct or indirect ownership of more than 50% of the voting potential (voting shares) of the subsidiary. There are other conditions for exercising control, for instance:

- the amount of voting shares exceeding 50% is achieved by an agreement with other investors and (or) ownership of appropriate financial instruments which, when executed or converted, can provide necessary additional votes (potential voting right);
- the ability to manage the financial and operating policies of the subsidiary in accordance with the charter or legislation;
- the ability to appoint or dismiss the majority of the board of directors;
- the ability to have the majority of votes on the board of directors.

The parent company should prepare consolidated statements in which it takes into account all subsidiaries, including a special purpose entity. In accordance with SIC 12, this is an entity created to perform a narrow range of tasks (for example, providing services for leasing assets, conducting research and development work, etc.). If the parent company exercises control over the activities of a special purpose entity, then the company must reflect this information when drawing up consolidated financial statements. The following factors may indicate that the special purpose entity should be controlled:

- the special purpose entity acts on behalf of the parent company;
- the parent company has the right to participate in the activities of the special purpose entity;

- the parent company has the right to most of the income of the special purpose entity.

Only subsidiaries with a temporary control should not be taken into account during the consolidation. The parent company does not provide consolidated financial statements in case when:

- the company itself is a subsidiary of another organization, and the main parent company does not object that the intermediate parent company does not prepare consolidated statements. However, one should keep in mind that if the intermediate parent company is not a wholly owned subsidiary, then the consent of its minority shareholders is also required;
- equity or debt instruments of such a parent company are not traded on the stock market;
- the intermediate parent company does not have to present the financial statements to the security commission or any other similar body for the purposes of floatation of equity or debt securities in the stock market;
- the ultimate or any intermediate parent company prepares consolidated financial statements for public access and which meet the IFRS requirements.

When preparing consolidated financial statements, the parent company must adopt the same accounting policy for similar transactions and other events under similar circumstances. Consolidation of the investment object begins from the moment when the investor obtains control over it, and ceases when the investor loses control over the investment object. The parent organization shall represent non-controlling interests in the consolidated statement of financial position regarding its equity separately from the equity of the parent company owners. Changes in the ownership interest of the parent company in a subsidiary that do not result in the parent company losing control of the subsidiary are viewed as capital transactions (that is, transactions with owners acting in that capacity). If the parent company loses control over the subsidiary, the parent company:

- derecognizes the assets and liabilities of the former subsidiary in the consolidated statement of financial position;
- derecognizes the fair value of any investment that remained in the former subsidiary as of the date of control loss and subsequently reflects the investment, as well as any amounts due from the former subsidiary in its favor, as provided in the relevant IFRS. This fair value is estimated as the fair value at first recognition of the financial asset in accordance with IFRS 9 or, if necessary, the cost of an investment in an associate or joint venture upon first recognition;
- recognizes the profit or loss associated with the loss of control attributable to the former controlling interest.

III. Results

Consolidated financial statements are formed within a single accounting policy of the group. If the accounting policy of a subsidiary on any objects of accounting or transactions does not comply with the accounting policy of the group, then for the purposes of consolidation, appropriate adjustments shall be made by the subsidiary. When preparing consolidated financial statements, the company consolidates line-by-line the financial statements of the parent and subsidiaries by adding similar items of assets, liabilities, capital, income and expenses. Consolidated financial statements shall present financial information about the group as a single economic organization, and the following actions are taken for this purpose:

- the book value of investments of the parent company in each subsidiary and the equity of each subsidiary owned by the parent company are eliminated (mutually excluded); the goodwill may be formed as a result of this combination, which is stated as a separate line in the consolidated balance sheet (positive goodwill is annually tested for impairment, negative goodwill is included in other profits);
- one determines the minority interest in the profit or loss of consolidated subsidiaries for the reporting period;
- minority interests in the net assets of the consolidated subsidiaries are stated separately from the shareholders' equity of the parent company.

Minority interest includes:

- minority interest in the net assets of the subsidiary as of the date of business combination, IFRS 3;
- minority interest in changes in equity of the subsidiary from the date of acquisition to the accounting date.

Consolidated financial statements present information on minority interest. The latter is understood as part of the net assets and part of the financial result (net or undistributed profit) of the subsidiary, attributable to the share that is not owned directly or indirectly by the parent company. In the consolidated balance sheet, the minority interest in net assets of subsidiaries is shown separately from the liabilities and capital of the parent company. The minority interest in net assets represents the sum at the date of the initial consolidation and the minority interest in the changes (increase) in the company's equity. The minority interest in the group's profits is shown separately in the consolidated statement of gains and losses.

Consolidated financial statements shall guarantee access of interested users to high quality, reliable and comparable information on a group of companies. Intra-group losses indicate impairment, which should be recognized in the consolidated financial statements. IAS 12 Income Taxes considers temporary differences arising from the elimination of gains and losses from intra-group transactions.

Therefore, this problem can be solved if groups of companies are obliged to compile consolidated financial statements in accordance with the IFRS provisions, as well as to conduct a compulsory audit and to publish reports in mass media. If the group members apply accounting policies that differ from those stated in the consolidated financial statements, appropriate adjustments should be made to ensure that they comply with the accounting policies of the group.

The company reflects income and expenses of a subsidiary in the consolidated financial statements from the moment of acquiring control over the subsidiary, and until the loss of control. The income and expenses of the subsidiary are calculated according to the assets and liabilities recognized in the consolidated financial statements as of the acquisition date. For example, depreciation expenses recognized in the consolidated statement of comprehensive income after the acquisition date is based on the fair value of the respective depreciable assets recognized in the consolidated financial statements as of the acquisition date.

When preparing the consolidated financial statements, derivative instruments reflecting potential voting rights, gains or losses ratio, as well as changes in equity, are attributable to the parent and non-controlling interests, and they are determined solely according to direct interests and do not reflect the possible performance or conversion of potential voting rights and other derivative instruments. Instruments reflecting potential voting rights in a subsidiary are reported in accordance with IFRS 9.

Financial statements of the parent company and its subsidiaries used when preparing the consolidated financial statements should be provided for the same reporting date. If this is not feasible, the parent company should consolidate the financial information of the subsidiary using the latest financial statements of the subsidiary, adjusted for significant transactions or events that occurred between the date of these financial statements were presented and the date of the consolidated financial statements.

In any case, the period between the date of the financial statements of the subsidiary and the date of the consolidated financial statements should not exceed three months, and the length of the reporting periods and the gap between the financial statement dates must coincide for each period. The profit, loss or each share of other comprehensive income is attributable to the owners of the parent company and non-controlling interests.

A parent company may lose control of a subsidiary when concluding two or more agreements (transactions). The presence of one or more of the factors considered below may indicate that the parent company should record several agreements as a single transaction. If the parent company loses control of the subsidiary, the parent company must account for all amounts recognized in other comprehensive income concerning that subsidiary.

Therefore, if a gain or loss previously recognized in other comprehensive income is reclassified when disposing of the related assets or liabilities, the parent company will reclassify the gain or loss from equity in the event it loses control of the subsidiary. If a revaluation surplus previously recognized in other comprehensive income is transferred directly to retained earnings when the asset is disposed of, the parent company transfers this increase in value from revaluation directly to retained earnings in case it loses control over the subsidiary. To ensure the correct understanding of the consolidated financial statements, the following information should be provided:

- a list of subsidiaries whose data are significant for the consolidated financial statements of the group, indicating the name, country of registration or location, interest or percentage of voting shares held by the parent company;
- reasons why the subsidiary is not included in the consolidated financial statements (if there are such companies);
- the nature of the relationship between the parent company and subsidiaries in which the parent company does not directly or indirectly own more than half of the voting shares;
- names of enterprises in which the parent company directly or indirectly owns more than half of the voting shares, but which are not subsidiaries as being not under control;
- the impact of the acquisition and disposal of subsidiaries on the financial position of the group at the reporting date, the results of its operation for the reporting period and the corresponding amounts for the previous period.

The development of a new IFRS 10 Consolidated Financial Statements that came into force on 01 January 2013 improved the procedure of determining the control of one company after another. The main purpose of IFRS 10 is to determine the principles for the presentation and preparation of consolidated financial statements.

IFRS 10 introduces a new definition of “control over a company”. It includes three components of control which should be implemented at the same time and which represent the criteria for the working control over the company. In accordance with this standard, the company is controlling, i.e. has control over another company (controlled), if:

- it has power over the company;
- has rights to various earnings, returns, i.e. the results of the relationships between companies and that are aimed at acquiring power, or are influenced by these results;
- it is able to use its power to influence the scope of these results.

In Kazakhstan publications, power over another company is defined as the ability and capacity to influence the activities of a company to achieve the goals set. Such power of the controlling company, as a rule, is based on the relevant legal

procedures, economic duress, compensation, economic relations. The right to vote (more than 50% of voting shares) should not be of crucial importance when determining the controlling and controlled entity. The controlling company may not have any amount of voting shares (stakes) of the controlled one.

For example, JSC Podgorny has gained control over the following companies after purchasing 100% of the voting shares of Ulan LLP and 100% participation in Dulat LLP and Sultan LLP. The cost of the acquired shares amounted to 1,750,000 tenge, the cost of participation in Dulat LLP – 635,000 tenge, in Sultan LLP – 80,000 tenge.

As the IASB observes, the Consolidated Financial Statements Standard differs mainly in the definition of control over structural elements in consolidated groups. Procedures for the reporting preparation, following the definition of the consolidation scope, remained unchanged. However, this standard requires the constant monitoring of all factors affecting the control, since it is important to establish a start date of control and a date of losing control over subsidiaries in order to recognize or derecognize their assets, liabilities, non-controlling interest, intercompany turnover and to make relevant changes for that date when preparing consolidated financial statements. To conduct such monitoring, it is necessary to identify the factors that mark these events.

When building a system that allows one to quickly determine the changes in the group composition of consolidated companies, one should bear in mind that the information about related parties should be included as data support for this system. The definition of related parties can be found in IAS 24 Related Party Disclosures, as well as information necessary for taxation on affiliated persons, the definition of which is given in the Tax Code of the Republic of Kazakhstan.

Accounting information and information necessary for taxation should correlate as fully as possible. Otherwise, as practice has shown, it makes accounting much more difficult with lower reliability of accounting information. In accordance with IAS 27 Consolidated and Separate Financial Statements, the consolidated financial statements are the financial statements of a group that includes one parent company and all of its subsidiaries.

However, in practice, there are often cases when a private person can control several companies, and these companies, in turn, are the parent ones for the companies controlled by them, i.e. the top level of the group (in terms of control) is occupied not by a single, but several entities that are not controlled by any of the group companies.

IV. Conclusion

The results of business operations of the subsidiary are included in the consolidated report from the date of its acquisition by the parent company. If a legal entity is acquired during the year, then, for consolidation purposes, its data on the results of financial and business operations for this year should be divided into two reporting periods: before and after the acquisition. It is hard to unify or formalize the procedure of bringing changes into the reporting, and it is not easy to set a single standard, while the list of possible differences can vary considerably depending on the type of activity.

The proposed methodology was developed to update the reporting of large business entities. Its computerized version was tested when updating the statements of JSC Podgorny in accordance with international financial reporting standards. The methodology can be used for solving internal management tasks in a group.

Specifics of the proposed methodology for reporting transformation include the detailed structuring of the objectives and tasks to be solved, as well as transformation procedures at each stage; it also provides required information support and a regulated list of developed documents and reporting forms (IFRS in Your Pocket, 2015).

The analysis and evaluation of the financial results of the integrated group and its financial position by external users of consolidated financial statements requires not only correct estimation of the scope of consolidation: when carrying out such an analysis, one should keep in mind that the companies that belong to a consolidated group may carry out various types of activities.

This applies to vertically integrated groups and groups with conglomerate diversification. In the consolidated financial statements, one should provide additional segmented information that enables to assess the nature and financial consequences of various activities, as well as to make informed decisions regarding the segments and the group as a whole.

In accordance with IFRS 8, it is necessary to identify operational segments for each activity. At the same time, if segments have similar economic characteristics, they can be combined into one. This enables to determine reportable segments, the information on which is provided in the consolidated financial statements. Having researched academic papers and corporate reports of large groups of Kazakhstan and international companies, we can conclude on what additional data should be selected as sufficiency criteria for each business combination regarding diversification of its activities.

Overall, the updating of the consolidated financial statements in accord with international standards aims to improve the quality and reliability of information about a group of companies.

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